

## Appeals Transmittal Memorandum and Case Memo

Date: NOV 03 2000

1. Routing To:

D.O.

APS

From: Appeal Code:

Houston Appeals

MS:HOU:AP:LMF

(281) 721-7244

Copy To:

2. Features:

- ☐ Examination or EP/EO Follow-up  
☐ Closing Agreement  
☐ Fraud Penalty Removal  
☐ Transferee Assessment  
☐ Form(s) 5479 Attached

- ☐ Restricted Interest  
☐ Trust Fund Recovery Penalty (TFRP)  
☐ Joint Committee  
☐ Audit Statement Attached  
☐ Offers in Compromise

- ☐ EP/EO Determination  
☐ Form(s) 885-F/4668 Attached  
☐ International Issue  
☐ Potential Competent Authority Case  
☐ Other

3. Taxpayer(s)

Puerto Quetzal Power Corp

P. O. Box 1188

Houston, TX 77251

4. Related Taxpayers:

Name:

Workunit No:

Year(s):

TIN/SSN No:

TIN:

76-0381261

Work Unit No.:

5299337007

Name:

Workunit No:

Year(s):

TIN/SSN No:

5. Tax Years: (\*KTY)

199512 &amp; 199612

Name:

Workunit No:

Year(s):

TIN/SSN No:

6. Type of Case:

Income

Workunit No:

Year(s):

TIN/SSN No:

7. Prior Findings:

8. Revised Findings:

Tax

Penalty

Tax

\$535,368.00

\$0.00

\$0.00

\$0.00

9. Disposal Information:

☒ Agreed, Form No. Decision Doc.☐ Unagreed☐ Review of Counsel Settlement☐ Foundation Classification☐ SND To Be Issued - Copy Attached☐ Premature Referral

Requested (See Remarks)

☐ Trial Preparation☒ Other (See Remarks)

10. Other Information:

No. Of Conferences

Taxpayer's Rep.

George M. Gerachis

District Counsel Att.

Docket No.

17311-99

Examiner:

J. Notter

/1107

11. Remarks and/or Supporting Statement:

SEE ATTACHED APPEALS CASE MEMO

Penalty Reason Code(s):

N/C Reasons Code:

ARDI Code(s): 7

Closing Code: 08

Conference Reason Code:

Senate Finance Committee

EXHIBIT 12

Signature/Date:

Lawrence M. Fagen 9-5-00  
Lawrence M. Fagen, Appeals Officer

AO's Grade:

14

Time:

345 hrs.

# Forms 5403:

2

14. Earliest Statute Date:

Docket 2-23-00

15. Approved ☒ Associate Chief

James M. Stryker, Associate Chief

Date:

9-5-00

District Counsel

Date:

## Schedule of Adjustments

Description	Tax Period	Examiner's Adjustment	Appeals Change to Adjustment	Appeals Adjustment	Reason Code
CGS - Fuel and Power	1995	1,534,539	(1,534,539)		0
2 Other Deductions -	1995	333,333	(333,333)		0
(Amortization)	1996	800,000	(800,000)		0
3 Environmental Tax Deduction	1995	(2,242)	2,242		0

## Reason Codes (no narrative):

A taxpayer now agrees  
B accepted by examiner

C taxpayer substantiated  
D computational adjustment

Puerto Quetzal Power Corporation \ 1995 & 1996 \ 17311-99

Lawrence M. Fagen, Appeals Officer

## ISSUE # 1 & 2

### SUMMARY AND RECOMMENDATION

Should \$1,534,539 be disallowed in 1995 because the amount hasn't been proved to be an IRC §162 item and that it was a reimbursable or amortizable expense. No, the non- IRC §162 position taken by the District wasn't sustainable as the examiner didn't develop the case beyond reliance on an informant's report which couldn't be used in Tax Court.

### BRIEF BACKGROUND

Puerto Quetzal Power Corp. is owned 50% by Enron Global Power & Pipelines L.L.C. and 50% by Centrans Energy Services, Inc. A branch of the TP operates an oil-fired, barge-mounted power plant in Guatemala that produces and sells electricity to Empresa Electrica de Guatemala (owned by Guatemalan government). In 1992 TP entered into an Operation and Maintenance Agreement (O & M) with Electricidad Enron de Guatemala, S.A. (EEG) which is wholly owned by Enron Development Corp. (EDC). EEG is the operator and TP agreed to pay EEG all reimbursable expenses under the O & M Agreement.

In 1993, TP and EEG amended the O & M to provide that the Project's fuel oil requirements would be supplied by Enron Power Oil Supply Corp. (EPOS), a domestic sister of EDC. EEG also agreed to make certain payments to Sun King Trading Co. (Sun King), an unrelated party, on behalf of TP. The District position is that Sun King payments don't represent an IRC §162 expense.

### DISCUSSION AND ANALYSIS

#### *What is the International Examiner's position?*

As a result of the EDC/Texas Ohio Power Co. (TOP) Agreement dated 03/12/92, EDC assumed TOP's previous obligation to Sun King. The services performed by Sun King group can be characterized as a "finder fee" arrangement. Sun King is not a formal business group, but instead a group of individuals which individually, or as a group, represented certain interest of TOP leading up to Empresa's signature on the 15-year power sales agreement. The government took the following position:

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Puerto Quetzal Power Corporation \ 1995 & 1996 \ 17311-99

Lawrence M. Fagen, Appeals Officer

- While PQPC did not directly pay the 1995 monthly obligation to Sun King, it directly provided the funds, and took a current period deduction for all funds transferred to the payor, EEG (billed by EEG to PQPC as reimbursable fees); nothing has been presented which suggests this “finder’s fee” is an “ordinary” expenditure benefiting only the current (1995) period operations of PQPC’s power plant. any benefit attaching to the 1995 monthly Sun King payments benefits more than just the current tax period.

The taxpayer can argue inheritance of the Sun King obligation was “necessary” for EDC to secure the Power Sales Agreement from TOP. But in order for the Sun King payments to meet the requirements of IRC §162, they must be both an ordinary and a necessary expense. Therefore, any expenditure incurred by PQPC (period 01/01/95 to 08/22/95), to fund the “finders fee” obligation to Sun King is disallowed under IRC §162.

*What is the petitioner’s position (along with applicable IE counter points)?*

Pursuant to the O & M Agreement, petitioner agreed to pay EEG, the operator, all “reimbursable expenses” on a monthly basis. Fuel oil expenses constituted “reimbursable expenses” under the O & M Agreement. Furthermore, the petitioner argues that payments made to Sun King are legitimate obligations under IRC §162.

*Why does the IE disagree with fuel oil being included in the O & M Agreement?*

According to the IE the O & M Agreement specifically defines “reimbursable expenses” and fuel oil is specifically omitted.

§1.29, Reimbursable Expense: Subject to §4.1, any reasonable expense or expenditure incurred by Operator in the performance of the work, including, without limitation, (i) purchases of spare parts, tools, equipment, consumables, materials and supplies (other than fuel), (ii) Labor Costs, (iii) the direct cost of subcontract labor or services needed to perform services otherwise covered by this agreement, (iv) insurance premiums and (v) any other item covered in an approved Annual Budget.

It appears from the above that Puerto Quetzal Power Corp. (PQPC) would not need to reimburse the operator Electricidad Enron de Guatemala, S.A. (EEG) for fuel costs. **Note: this fuel exception will be deleted in a subsequent revision to the O & M Agreement on 03/31/93.**

What is PQPC's position on payments made to Sun King Trading Company (Sun King)?

On March 13, 1993 PQPC and EEG amended the O & M Agreement to provide that the Project's fuel oil requirements would be supplied by Enron Power Oil Supply Corp. (EPOS), a domestic sister company of EDC. EEG also agreed to make certain payments to Sun King, an unrelated party, on behalf of PQPC. The payments to EEG as well as the payments to Sun King were ordinary and necessary expenses deductible under IRC §162.

Main TP argument is if PQ (Enron) did due diligence when they (EDC) entered into an agreement with TOP the payments to Sun King are good. In other words EDC wasn't obligated to do an investigation into the operations of Sun King to assure the moneys flowing to Sun King were for completely legitimate purposes and never would be construed as anything otherwise. They felt they were paying for the service of obtaining and maintaining a contract with EEG. Sun King provided that service and was being paid. Enron decided it was better to make the lump sum payment of \$12,000,000 as it was more attractive for investors not to see the long-term obligation on the books.

How does the IE view the Sun King payments, in view of the O & M Agreement and it's subsequent amendment and a new fuel agreement?

Basically, the IE says that Sun King is eliminated from the arrangement as a result of modifications and a new fuel contract. The following is argued:

Amendment #1 to the O & M Agreement dated 03/31/93 is between PQPC and EEG. §1.13 of the O & M Agreement dated 11/13/92, is deleted in its entirety and the following provision substituted:

§1.13 Fuel Agreements: The fuel supply and transportation agreements for the Project's fuel oil requirements, entered into

(i) on 10/06/92, between Enron Power Marketing Co. (EPMC) and Enron Power Corp. (EPC), as modified by that certain Modification of Agreement dated 03/30/93 between EPC and EPMC and as assigned by EPC to Enron Power Oil Supply Corp. (EPOS) pursuant to that Assignment and Assumption Agreement dated as of 03/31/93, and

(ii) on 10/27/92, between Texaco International Traders, Inc. (Texaco) and EPC, as modified by that certain Modification of Agreement dated 03/30/93 between EPC and Texaco as assigned by EPC to EPOS pursuant to that Assignment and Assumption Agreement dated as of 03/1/93...

§1.29 of the O & M Agreement is hereby deleted in its entirety and the following provision substituted:

§1.29 Reimbursable Expense: Subject to §4.1, any reasonable expense or expenditure incurred by Operator in the performance of the work, including, without limitation, (i) purchases of spare parts, tools, equipment, consumables, materials and supplies, including fuel oil which Operator supplies or causes to be supplied to Owner hereunder...

On 04/01/93, a Fuel Supply and Management Agreement was entered into by and between EEG (operator) and EPOS. §5 of this Agreement provides in part:

Price; Payments: In exchange for the fuel supply and management services to be provided by EPOS hereunder, Operator agrees to pay, or cause to be paid, to SPOS an amount each month equal to the sum of

(i) an amount equal to 6% of the gross monthly revenues of PQPC in such month (monthly fee), and

(ii) the invoice amounts actually paid by EPOS to its fuel oil suppliers to procure the supplies that are delivered in such month pursuant to this Agreement...

The IE maintains that as a result of Amendment #1 to the O & M Agreement dated 03/31/93, and the Fuel Supply & Management Agreement dated 04/01/93, nothing is mentioned regarding EEG's (operator) agreement to make certain payments to Sun King, on behalf of PQPC (owner).

(Appeals) I infer that the IE is saying there's no business purpose in PQPC's payments to Sun King.

*Note: According to the IE Sun King is a Panamanian corporation. The nature of the payments is that of a finder's fee according to the IE, not to be expensed or amortized*

How does petitioner attempt to justify the Sun King payments?

During 1995 PQPC paid a total of \$18,437,704 to EEG for operating and maintenance services actually performed for the Project by EEG, payments actually made to Sun King in PQPC's behalf, and fuel oil actually supplied to the Project by or through EPOS, all pursuant to the O & M Agreement. The \$1,534,539 at issue was part of such payment to EEG and constitutes an ordinary and necessary expense of PQPC that is fully deductible in 1995.

## MY EVALUATION

### What is Sun King doing and in what capacity?

The TP provided a copy of an Agency Agreement between TOP and Sun King (a Guatemalan Corporation), in which Sun King is to act as an agent for TOP. As an agent, Sun King purports to:

- be the proprietor of certain documents, information and knowledge relevant to E.E.G.'s electrical energy requirements;  
have sufficient knowledge, expertise and contacts to facilitate execution of a contract between TOP and E.E.G.;
- be able to make all necessary and other reasonably requested introductions;
- assist in facilitating communications between TOP and key personnel of E.E.G.
- be a facilitator for negotiations and timely execution of the Power Generation Facility Purchase and Sale Agreement;
- make available all information which is pertinent to the Power Generation Facility Purchase and Sale Agreement between TOP and E.E.G.  
be able to provide all necessary initial and ongoing permits and consents of the Government of Guatemala, including without limitation, all regulatory bodies;  
be able to obtain reasonable exemptions from all tariffs and import duties for all equipment and supplies reasonably necessary for TOP's continued operation.

Some of the above benefits resemble those that a government could grant if TOP were to negotiate directly with Guatemala. Some observations about Sun King's unusual nature to have the ability to provide the benefits and privileges so broad in scope are who are these people in Sun King that have this power and how did they acquire the expertise? Are the Sun King principals:

- agents of the Guatemala government;  
members of TOP's staff or board of directors;
- providing this service to other companies;  
have a history of providing similar services before the agreement and after?

The case file is devoid of any details on the above, other than to say that the District believes the people involved with Sun King were friends and appeared to be no more than brokers between the Guatemalan government and TOP (part of 3<sup>rd</sup> party information). There was no investigative work done in this area by the government to prove or disprove the business relationships or abilities of those associated with Sun King.

In conference, the TP was asked to provide information as to how they knew if the money they were paying was being used for the items outlined in the agreement. They said they were going to contact a former Enron employee to see if he could shed more light on the subject. They adamantly argued that the contract was taken over by Enron and they were not required to do a complete investigation into Sun King before following the contract which was already in existence. In other words, Enron is purchasing a package that included the Sun King obligation; is it their responsibility to challenge the propriety of the contract before signing up because in the future someone may say the Sun King group was bogus as far as providing services is concerned?

The District states that the fees to Sun King aren't IRC §162 because they represent a finder's fee. Furthermore, the IE states that:

- Sun King is not a formal business group, but instead a group of individuals which individually, or as a group represented certain interest of TOP leading up to EMPRESA's signature on the 15-year power sales agreement.
- Nothing has been presented which suggests this "finders fee" is an "ordinary" expenditure benefiting only the current (1995) period operations of PQPC's power plant.

Any benefit attaching to the 1995 monthly Sun King payments benefits more than just the current tax period.

The IE further argues that since the "finders Fees" are not enumerated as capital expenditures qualifying as an IRC §197 Intangible, amortization is the provided by IRC §197(a) for either:

- (a) the \$12,000,000 lump sum payment, or
- (b) the total \$1,534,539 in monthly payments tended Sun King

*How does the District back-up the above contention that Sun King is a finder fee arrangement?*

There is no investigative work in the case file by the IE to back-up the contention; the agent didn't do further work on Sun King to either question or affirm that Sun King does or doesn't do the items listed in the agreement (performance of duties listed above in this Evaluation). The IE's main premise is that the TP hasn't proven that the fee is nothing more than a finders fee.

When I asked the questions about the agreement in conference and referred back to the duties listed for Sun King to perform, the POA said I was the first to make this detailed inquiry and wanted to know if the IE had a supplemental report with more evidence to support his position.



There is information from a third party that speculates to the above allegation. However, the IE didn't pursue an investigation based on the third party information to either disprove it or prove it (perhaps this was due to the TP's reluctance to extend the statute). Instead the IE stands on the premise that the TP can't prove the amounts paid are nothing more than a finders fee.

The third party can't be called as a witness as the privacy protection would be violated. The government, at this point without a Sun King investigation, can only rely on the IE's contention that the TP can't prove the payments aren't a finders fee.

*What has the TP done to defend the deduction as a legitimate expense?*

The TP offers the following regarding Sun King:

Sun King Trading was an entity formed by a small group of businessmen, including several wealthy Guatemalans, possibly to participate in the privatization of the electric power business in Guatemala. Enron is not aware of any reason for its formation.

The principals of Sun King included the following, all of whom were prominent businessmen in Guatemala:

**Raul Arrondo**— Mr. Arrondo was a Miami-based Cuban who sold small engines that generated electricity. He had a business relationship with Patrick La Strapes, the President of TOP. They met when TOP was involved in small power projects. Mr. Arrondo's engines were not the kind used to generate electricity in large power plants, however. They were more suitable as back-up electric power sources for sugar plantations, farms, offices, etc. Mr. Arrondo also was active in Guatemala, which was an excellent market for his generators because of the frequent power failures in Guatemala. Several of the other principals of Sun King were his customers.

**Oswaldo Mendez Herbruger**— Mr. Herbruger, a former Olympic athlete (and subsequently Guatemala's Minister of Sports and Culture), was a businessman. His family had built some of the first merchant power plants in Central America.

**Marco Antonio Lara**— Mr. Lara was a plantation owner and a customer of Mr. Arrondo.

**Roberto Lopez**— Mr. Lopez was a business agent, primarily representing foreigners who wanted to invest in Guatemala.

**Henrik Preuss**— was a wealthy businessman, with interests in sugar, coffee, textiles and shipping.

Mr. Arrondo knew first hand about the acute power shortages in Guatemala. His friend, Mr. La Strapes, persuaded him that the time was ripe for Guatemala to re-privatize the electric power industry. Mr. La Strapes represented to Mr. Arrondo that with the combination of Mr. Arrondo's understanding of generators, TOP's power project development experience, and some engineers and others, Mr. La Strapes had all the skills necessary to bring private power to Guatemala. All that was missing were some high profile Guatemalan business people as investors and partners. Mr. Arrondo's customers appeared to fit the bill.

None of the Sun King principals were agents of the Guatemalan government, nor were they members of TOP's staff or board of directors. Both Sun King and TOP were entities wholly unrelated to Enron.

Although the Sun King principals were experienced business people, they had never constructed or operated a power plant. Thus, they also had no way to evaluate the economic risks or potential returns of the deal. They looked to TOP to handle the construction and operation, and to assume the financial risk, of the Guatemala Project. They were reluctant to risk capital in the project. Originally, Sun King wanted a lump sum fee for the services it rendered. TOP was not well capitalized, however, and negotiated a contingent payment. Sun King insisted on receiving a royalty, rather than a profit interest, wanting to be paid regardless of whether the project was profitable or not.

After the PPA and the Agreement had been executed, it became increasingly apparent that TOP did not have the financial capacity or the experience to make the Guatemala Project successful. With Sun King's encouragement, TOP began contacting potential partners. After being approached by TOP in February 1992, Enron became interested in the project. Enron had been looking for potential privatization opportunities in Central America. At the time Guatemala was not on the radar screen of many foreign investors, so Enron assumed it might not face much competition. It was mistaken. A potential supplier of generating equipment, Wartsila Diesel, Inc. ("Wartsila") was also interested in becoming a partner in the project. After intense negotiations, Enron won the right to be the new investor.<sup>1</sup>

Enron did extensive due diligence before agreeing to take on the project. Enron's model for international power project development was to obtain as much limited recourse financing as possible so as not to take on too much financial risk. In order to obtain such financing, the PPA would have to be valid and enforceable. Satisfied with its due diligence, Enron insisted on taking over the project from TOP. Enron agreed to pay certain amounts to TOP and to assume TOP's rights and obligations under the Agreement and the PPA. Enron also tried to renegotiate

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<sup>1</sup> Ultimately, an agreement was reached among the parties by which Enron would be awarded the bid for the Guatemala Project but Wartsila would be awarded the turnkey construction contract on the project.

the Sun King royalty to shift more risk to Sun King. Sun King resisted, so Enron assumed the royalty obligation.

While it was negotiating with Sun King and TOP, Enron began looking for other equity investors and a lender. It ultimately persuaded King Ranch Oil & Gas, Inc. ("King Ranch") to acquire a 50-percent interest in the project. It also persuaded the International Finance Corporation ("IFC"), a unit of the World Bank, to lend \$71 million of the approximately \$95 million required for the project.

Not surprisingly, each of King Ranch and IFC did their own extensive due diligence into the validity of the contracts, including the PPA and the Agreement. In a March 8, 1993 letter to Enron Power Corp., King Ranch made clear that its purchase of an interest in PQPC would be subject to (a) its review and approval of all material agreements and documents affecting its equity interest and the project and the business, prospects, and liabilities related thereto, and (b) its review and approval of past and present compliance with local and U.S. law in connection with the project, including, but not limited to, compliance by Enron Power Corp. and its agents with the Foreign Corrupt Practices Act. King Ranch ultimately consummated its purchase of a 50-percent equity stake in the Guatemala Project.

Thus, it clearly was satisfied by the results of its independent review of the foregoing items. IFC also did extensive due diligence, including interviews of representatives of both EEGSA and Sun King. IFC was satisfied there were no improper relations between the two entities, and it proceeded with its \$71 million limited recourse loan, requiring only the standard representations and warranties.<sup>2</sup>

#### *What is the Enron / SunKing Relationship?*

Enron is not aware of any agreement between Sun King and EEGSA pursuant to which Sun King agreed to represent EEGSA in negotiations. To the contrary, Enron always observed Sun King on the opposite side of the negotiating table from EEGSA.

2. Enron believes Sun King is not still in existence. Enron's last transaction with Sun King was the payment to Sun King that is at issue in this case.
3. Enron was not involved with the Guatemala Project before February of 1992, and was not involved with the negotiations leading up to the Agreement or the execution of the Agreement. Thus, Enron does not know why Sun King was referred to in the Agreement as a Guatemalan corporation. Enron has since confirmed that Sun King was a

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<sup>2</sup> Wartsila ultimately became the turnkey construction contractor for the project and did its own due diligence

Panamanian corporation. It may be that Sun King operated in Guatemala as a branch of the Panamanian corporation.

4. The principals of Sun King included the following five individuals: Raul Arrondo, Oswaldo Mendez Herbruger, Marco Antonio Lara, Roberto Lopez and Henrik Preuss.
5. Sun King approached TOP about development of the Guatemala Project. Sun King learned of TOP through R.B. Grove, a Miami company owned by Raul Arrondo that sold power generators. R.B. Grove had connections with Waller Marine in Houston, who referred Sun King to TOP.
6. Enron dealt with the principals of Sun King, specifically Oswaldo Mendez Herbruger and Henrik Preuss, with respect to the royalty payments under the Agreement. Henrik Preuss did most of the negotiating on behalf of Sun King, although all were involved. Mr. Preuss currently is the president of Centrans Energy, an unrelated third party. Centrans Energy ultimately became Enron's partner in the Guatemala Project, purchasing a 50-percent interest on January 8, 1996.
7. The \$12 million lump-sum payoff amount made by Enron to Sun King was a result of arm's-length negotiations between Enron and Sun King, two unrelated entities. Enron calculated the buyout amount it was willing to offer by comparing a lump sum payment with the projected royalty payments it otherwise would have made, discounted to reflect the project's risk.

Based on such assumptions and calculations, Enron first offered approximately \$10 million to Sun King in satisfaction of the royalty obligation. Sun King countered with a demand for \$15 million. The parties obviously had differing views of the riskiness of the future cash flows from the Guatemala Project. The parties' extensive negotiations ultimately led to a termination payment of \$12 million.

#### Conclusion:

The government cannot refute any of the above without an investigation into Sun King activities. Appeals is not the venue for this type of activity. I asked the questions that led to the majority of the above information. As an appeals officer I was becoming the developer of the issue, as these areas were not touched during the examination. Since the basis of the District's argument is data that cannot be used in court, the government has insurmountable hazards in pursuing the premise that Sun King is nothing more than friends getting together and charging a finders fee. Therefore, I recommend full concession of both issues, as the contention that Sun King is not an IRC §162 expense cannot be sustained.